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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. ...755

ISADORE BLAU, a stockholder of Northwest Airlines, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Northwest Airlines, Inc.,

Petitioner,

against

ALONZO PETTEYS and C. FRANK REAVIS,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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IN THE

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Petitioner,

against

ALONZO PETTEYS and C. FRANK REAVIS,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

TO THE HONORABLE, THE CHIEF JUSTICE AND ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Your petitioner, Isadore Blau, a stockholder of Northwest Airlines, Inc. (Airlines), acting on behalf of himself and the other stockholders of said corporation, respectfully prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, rendered October 19, 1966, which reversed the judgment entered against the respondents in the United States District Court for the District of Minnesota, Fourth Division (R. 22).*

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* References are to pages of record certified to this Court by the Clerk of the United States Court of Appeals for the Eighth Circuit.

Opinions Below

The opinion of the District Court (R. 114a-121a) is reported in 246 F. Supp. 526. The majority and dissenting opinions of the Court of Appeals (R. 1-21, Appendix, *infra*, pp. 15-35) have not yet been reported.

Jurisdiction

The judgment of the Court of Appeals (R. 22, Appendix, *infra*, p. 36) was entered on October 19, 1966.

Jurisdiction is conferred upon this Court by 28 U.S.C., Section 1254(1).

Questions Presented for Review

1. Where directors of a listed issuer voluntarily convert their issuer's convertible preferred stock into common, and then sell such common shares less than six months later, do such acquisitions of the common shares constitute "purchases" thereof under the language and meaning of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78c(a)(13) and 78p(b)?

2. Under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), does the Court have the authority, which the Congress specifically and exclusively delegated to the Commission alone, to exempt from the statutory operation a transaction embraced within the express language and intended meaning of that statute, although the Commission itself has not promulgated any rule granting such an exemption?

3. Under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), in order for an "insider's" conversion of his issuer's convertible equity secu-

rities to be construed a "purchase" of the shares acquired thereby, must the issuer, or a stockholder suing on its behalf, bear the burden of proving that such conversion was the type of transaction which could possibly lend itself to the speculation encompassed by that statute?

Statutes Involved

Pertinent provisions of the Securities Exchange Act of 1934, Sections 3(a)(13), 3(a)(14), 16(a) and 16(b), 15 U.S.C.A., Sects. 78c(a)(13), 78c(a)(14), 78p(a) and 78p(b), pages 235, 322, 62 cum. supp., are set forth in Appendix, *infra*, at pp. 37-38.

Statement of Facts

An action was instituted by petitioner, Blau, as a stockholder of Airlines, pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78p(b), to recover the profits realized by the respondents, Petteys and Reavis, as the result of their respective purchases and sales of Airline's common stock within a period of less than six months (R. 60a-63a).

The basis for jurisdiction of the United States District Court for the District of Minnesota, Fourth Division, to which court such action had been transferred,* is Section 27 of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78aa.

During all material times here involved the respondents, Petteys and Reavis, were directors of Airlines (R. 24a-25a). Airlines' shares of common stock have at all times

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* The action had been instituted initially in the United States District Court for the Southern District of New York and had been transferred to the District Court of Minnesota upon respondents' motion.

been listed on the New York Stock Exchange; its Convertible Preferred shares were listed on such Exchange until the latter part of February, 1963 (R. 22a).

The Preferred stock was convertible into common at any time prior to January 1, 1964 at the conversion price of $26 per share plus accrued dividends (R. 22a, 67a).

On January 14, 1963, the Board of Directors of Airlines passed a Resolution calling the Convertible Preferred stock for redemption on February 14, 1963 at $26.16 per share (R. 25a, 67a). The market value of such Preferred stock on the date of the redemption Resolution ranged between $34-$34½ per share (R. 28a). The respondents, Petteys and Reavis, as directors of Airlines, *voluntarily voted for the redemption Resolution* (R. 102a).

On January 17, 1963, when its market price was between $35⅛-$35¼ per share, the respondent, Petteys, *voluntarily* converted 5,000 shares of Airlines' Preferred stock into 4,808 shares of common; less than six months later, i.e., between May 27, 1963 and June 18, 1963 he sold 9,808 shares of the common stock at prices ranging between $51-$55½ per share (R. 26a-28a).

On January 31, 1963, when its market price was $38¼ per share, the respondent, Reavis, *voluntarily* converted 1,167 shares of Airlines' Preferred stock into 1,123 shares of common; less than six months later, i.e., on June 5, 1963, he sold 1,600 shares of the common stock at prices ranging between $53¼-$53⅝ per share (R. 27a, 28a).

On February 25, 1963, eleven days after the redemption date, the Board of Directors of Airlines increased the quarterly dividends on the common stock from 20¢ to 25¢ per share (R. 107a).

Following the Board's action with respect to the increase of such dividends, the market price of the common shares increased substantially (R. 28a, 107a).

Based upon such undisputed facts, all parties, with the exception of Airlines, moved for a summary judgment (R. 18a-19a, 70a-72a, 97a-98a). The district court held that the respondents' respective acquisitions of the common stock through their voluntary conversions of the Preferred constituted "purchases" of the *common* shares under the language and meaning of Sections 3(a)(13) and 16(b) of the Securities Exchange Act of 1934. It further held that since the respondents had sold the common shares of Airlines less than six months after their "purchases" of such stock, any profits realized from these transactions were recoverable from the respondents under the applicable provisions of Section 16(b) of the Act. Accordingly, the court granted a summary judgment against the respondents in the aggregate sum of $102,519.56 (R. 114a-125a).

In accordance with the order granting its application, the Securities and Exchange Commission thereafter filed its *amicus curiae* memorandum with the Court of Appeals in support of the district court's judgment. The Court of Appeals reversed the judgment of the district court, with a dissenting opinion by Judge Blackmun.

Instead of applying the literal language of the statute and its *"objective"* approach with respect to the stock conversions, the majority of the Court applied a *"subjective"* test under which it concluded that the respondents' acquisitions of the common stock through their conversions of the Preferred did *not* constitute Section 16(b) "purchases" of the *common* shares because such transactions allegedly "could not possibly have lent itself to the speculation encompassed within the purposes of Section 16(b) of the Act" (R. 18, Appendix, *infra*, p. 32).

The dissenting opinion held, on the other hand, that the express language of the statute and its *"objective"* application *required* that the respondents' acquisitions of the common shares be construed Section 16(b) "pur-

chases'' because ''the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application'' (R. 20, Appendix, *infra*, p. 33).

Reasons Relied on for Granting the Writ

1. The Court of Appeals for the Eighth Circuit has decided an important question of federal law which has not been, but should be settled by this Court. The interpretation of the federal statute by the Court of Appeals finds no sanction in the language of the statute itself and is in conflict with legislative history and purpose which prompted its enactment.

2. The majority opinion of the Court of Appeals for the Eighth Circuit conflicts directly with the majority *en banc* opinion of the Court of Appeals for the Third Circuit in *Heli-Coil Corporation* v. *Webster* (C. A. 3, 1965), 352 F. 2d 156. As the result of such conflicting decisions, a chaotic condition of uncertainty and confusion has arisen with respect to the proper interpretation and application of Section 16(b) of the Securities Exchange Act of 1934, which can only be resolved by this Court.

ARGUMENT

I

The Court below has decided an important question of Federal law contrary to the express statutory language and its legislative history and contrary to prior interpretative decisions.

The stated purpose of Section 16(b) of the Securities Exchange Act of 1934 is ''preventing the unfair use of in-

side information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer." The statute imposes liability upon such "insider" for all profits realized by him from his purchases and sales of his issuer's equity securities within less than six months, "irrespective of (his) intention in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months."[1]

The statutory language, as well as its legislative history, clearly demonstrate that the insider's liability was intended to be predicated solely upon an *objective* test which would require no proof that the insider actually obtained any confidential information or that he misused it for his personal benefit in effecting his short-term transaction.[2] Such considerations were deemed "entirely irrelevant"[3] upon the theory that "if only those persons were liable who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered as to defeat its whole

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[1] The relevant statutory provisions are set forth in the Appendix, *infra*, p. 37.

[2] The operation of Section 16(b) was explained by Thomas G. Corcoran, the Administration's spokesman at the hearings which led to its adoption, as follows:

> "That is to prevent directors receiving benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it would be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Stock Exchange Practices, Hearings Before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess., pt. 15 (1934), pp. 6463, 6557.

[3] *Ferraiolo* v. *Newman* (C. A. 6), 259 F. 2d 342.

purpose.'"[4] Moreover, it was felt that "had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so."[5]

The Congressional hearings antedating the enactment of Section 16(b) of the Act had disclosed that options, conversions and similar devices lent themselves quite readily to abuses involving unscrupulous short-term trading by corporate insiders.[6]

In order to close off this avenue against active insider abuse, Congress expressly *broadened* the ordinary definitions of "purchase" and "sale" to *include* within their scope "any contract to buy, purchase, or otherwise acquire", and "any contract to sell or otherwise dispose of."[7]

In most instances where an insider has voluntarily converted his issuer's convertible securities the courts have generally applied such statutory definitions to the transaction involved by construing the conversion to be a Section 16(b) "purchase" or a "sale".[8]

By expressly eliminating all considerations with respect to the insider's *subjective* purpose in effecting his short-swing transaction, Congress clearly evinced its intention

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[4] *Gratz* v. *Claughton* (C. A. 2), 187 F. 2d 46, 50.

[5] *Smolowe* v. *Delendo Corp.* (C. A. 2), 136 F. 2d 231, 239.

[6] *Booth* v. *Varian Associates, Inc.* (C. A. 1), 334 F. 2d 1, 3-4; See, S. Rep. No. 1455, 73d Con. 2d Sess. (1934), pages 55-68; S. Rep. No. 792, 73d Cong. 2d Sess. (1934), pages 7-9; H.R. Rep. No. 1383, 73d Cong. 2d Sess. (1934), page 13.

[7] See Sections 3(a)(13) and 3(a)(14) of the Act, *infra*, page 38.

[8] *Park & Tilford, Inc.* v. *Schulte* (C. A. 2), 160 F. 2d 984; *Blau* v. *Lehman* (C. A. 2), 286 F. 2d 786, aff'd 368 U. S. 403; *B. T. Babbitt, Inc.* v. *Lachner* (C. A. 2), 332 F. 2d 255; *Booth* v. *Varian Associates, Inc.* (C. A. 1), *supra; Heli Coil Corp.* v. *Webster* (C. A. 3), 352 F. 2d 156.

that the provisions of Section 16(b) should be applied *automatically* to such transaction *without prior inquiry* as to its fairness or its susceptibility to the statutory evil, "even though it may cover instances where it (the evil) is *not* present."[9]

Such purposeful simplicity in the statutory application was intended to operate as one of its greatest deterrents in discouraging the insider from engaging in short-term speculation in his issuer's securities and his possible misuse of inside information in connection therewith. In order not to envelop the execution of the statute in a morass of factual and legal issues which would tend to vitiate the simplicity of its operation and destroy its effectiveness, the statutory application demanded "the necessity of having a general rule"[10] to be applied *alike* in *all* cases, except in those instances where the Commission by rules and regulations may have exempted the transaction as "not comprehended within the purpose of this subsection (Section 16b)".

Although in its majority opinion the Court of Appeals seems to have conceded that the respondents' acquisitions of their common shares through the conversions of the Preferred constituted Section 16(b) "purchases" under the express statutory definition of that term and "within the literal boundaries of the Act", it refused to follow such an objective and literal approach to the problem.

But as Judge Blackmun so aptly pointed out in his dissenting opinion,[11] "* * * either the statute means what it

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[9] *Gratz* v. *Claughton* (C. A. 2), *supra*, at page 50.

[10] "You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule." *Hearings on Stock Exchange Practices, supra*, note 2, at p. 6558 (testimony of Corcoran).

[11] Appendix, *infra*, p. 33.

literally says or that it does not; that if the Congress intended to provide additional exceptions (to the statutory application), it would have done so in clear language; and that the recognized purpose and aim of the statute are more consistently and protectively served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application".

In discarding such an *objective* and *literal* approach clearly intended by the Congressional mandate, the majority of the Court chose instead to substitute a *subjective* test to the transactions involved by examining all the surrounding facts to determine whether the respondents' conversions were susceptible to the abuses against which Section 16(b) was designed. It laid down the rule that "each case must be examined on its own facts and the Act only applied when these facts disclose the possibility of abuses that the Act were designed to prevent."[12] Applying such a *subjective* test, the majority concluded that the respondents' acquisitions of the common shares did not constitute Section 16(b) "purchases" because their conversions of the Preferred stock allegedly were not susceptible to the statutory abuses.

We believe that such a narrow, restricted view of the statute's application is erroneous, illogical and completely repugnant to the legislative intent because the history and express language of Section 16(b) clearly indicate that Congress intended to eliminate such a subjective test on a case-by-case basis. For under such a test the applicability of Section 16(b) to a particular short-swing transaction would always remain uncertain and nebulous and dependent upon the proof of factual issues, which would completely destroy the intended effectiveness of the statute and its "sure and speedy" remedy.

Moreover, if the Courts were permitted to apply a subjective test upon a case-by-case basis to determine whether

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[12] Appendix, *infra*, at p. 22.

the transaction involved were susceptible to the statutory abuses, this would be tantamount to empowering them to exempt a transaction from the statutory operation as not comprehended within its purpose.[13]

But *nowhere* in the statute or its legislative history does it appear that Congress intended to empower the *courts* to exempt transactions from the operation of Section 16(b). On the contrary, under the express language of that statute, such exemptive powers were granted *exclusively* to the Commission to whom the administration of the statute was expressly entrusted. The Courts have not been authorized to pre-empt such powers.

The rationale of the majority opinion, if permitted to stand, would have far reaching implications beyond the immediate issue here involved. For, not only would its subjective test for the statutory application be required in the case of conversion transactions alone, it would necessarily be required to be followed in cases where the insider exercises an option to acquire his issuer's stock, in cases where he exchanges his issuer's shares for the securities of another corporation, in cases where he received his issuer's shares in exchange for property, and in numerous similar situations. In fact, it is entirely conceivable that an insider might urge in the future that his ordinary *cash* purchases and sales of his issuer's securities within less than six months are exempted from the statutory application unless they can be *proven* to be susceptible to the proscribed abuses.

Such uncertainty with respect to the statutory operation is contrary to its intended purpose as well as its language and would result in a complete emasculation of its prophylactic provisions.

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[13] The Commission itself had not exempted the respondents' conversions from the operation of Section 16(b).

II

The decision by the Court below is in direct conflict with the decision rendered by the Court of Appeals for the Third Circuit.

In holding that the respondents' voluntary conversions of Airlines' Preferred into common stock did not constitute Section 16(b) "purchases" of the common,[13a] the Court of Appeals for the Eighth Circuit laid down the rule that, in every case involving an insider's conversion of his issuer's convertible security, the test as to whether such conversion constitutes a Section 16(b) "purchase" or a "sale" must be determined upon a *"subjective"*, rather than an "objective", evaluation of the transaction itself, its attendant circumstances and its ultimate effect. Under such a *"subjective"* test the issuer, or a stockholder suing on its behalf, would be required to prove as a *sine qua non* for the statutory application, that the insider's voluntary conversion of his issuer's convertible security afforded him with some opportunity to misuse his inside information. *Unless* such proof was forthcoming to show that such conversion was susceptible to the statutory abuse, it would *not* be construed a Section 16(b) "purchase" or a "sale".[14]

The recent decision by the Court of Appeals for the Third Circuit in *Heli-Coil Corp.* v. *Webster* (C. A. 3, 1965), 352 F. 2d 156, conflicts directly with the decision of the Eighth Circuit in the case below.

In *Heli Coil* the insider had purchased his issuer's convertible securities and had then voluntarily converted them into common stock less than six months later. In holding

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[13a] Both respondents, as directors of Airlines, had voted in favor of the Resolution authorizing the redemption of its Preferred stock, and they had also voted in favor of increasing the dividend on the common shares thereafter.

[14] The Eighth Circuit followed the recent Second Circuit's decision to the same effect in *Blau* v. *Lamb* (C. A. 2, 1966), which is still unreported. A petition for a writ of certiorari (No. 720) was filed with this Court in the *Lamb* case but has not yet been acted upon.

that the insider's conversions constituted Section 16(b) "sales" of the convertible securities, the Court of Appeals for the Third Circuit laid down the rule that the proper test for determining whether an insider's voluntary conversion of his issuer's securities constitutes a Section 16(b) "purchase" or a "sale" must be predicated upon an *"objective"* test, rather than upon a "subjective" one. It further held that under such an *"objective"* test, it was entirely immaterial and unnecessary for a determination of the issue whether or not the insider's voluntary conversion was susceptible to the statutory abuse. The incidence of his relationship to the issuer was all that the statute required.[15]

Although the majority in the Eighth Circuit specifically recognized that its decision completely conflicted with both the rationale and result in the *Heli-Coil* case, it sought to justify its ruling upon the ground that the *Heli-Coil* decision is "at present a minority ruling and is founded almost solely upon the rationale of *Park & Tilford*. Since *Park & Tilford* has now been severely limited by the later Second Circuit decisions on this issue, we cannot refrain from the belief that *Heli-Coil* is likewise weakened."[16]

Regardless as to whether *Heli-Coil* is presently "a minority ruling", however, it is inescapable that such decision has created a clearly delineated division and conflict between the various Circuit Courts as to the proper interpretation and application of Section 16(b) of the Act. This conflict of ideology has already led to considerable confusion which undoubtedly will continue to be compounded in future cases unless this Court finally resolves the matter. Such confusion and uncertainty now "leaves this important area of the law almost ludicrously uncertain". Unless this Court charts the proper course for its statutory

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[15] The *Heli-Coil* case was decided by the Court *en banc* with 6 of the judges voting in favor of such "objective" approach to the statutory application, while 2 judges dissented therefrom.

[16] Appendix, *infra*, pp. 26-27.

interpretation, courts in different Circuits will continue to decide Section 16(b) cases by applying different standards in each case. This can only lead to complete deterioration and ultimate destruction of the statute's intended purpose.

As Judge Blackmun so aptly observed in his dissenting opinion:[17] "Perhaps the Supreme Court one day soon will tell us how these somewhat conflicting approaches to Section 16(b) by the Courts of Appeals are to be resolved."

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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[17] Appendix, *infra*, p. 35.

APPENDIX

Opinion.

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

Nos. 18,277-18,278

Alonzo Petteys and C. Frank Reavis, Appellants,

v.

Eunice S. Butler and Northwest Airlines, Inc., Appellees.

Alonzo Petteys and C. Frank Reavis, Appellants,

v.

Isadore Blau and Northwest Airlines, Inc., Appellees.

} Appeals from the United States District Court for the District of Minnesota.

[October 19, 1966.]

Before VAN OOSTERHOUT, BLACKMUN and GIBSON, Circuit Judges.

This appeal presents another difficult question on the applicability of the sanctions of § 16(b) of the Securities

Exchange Act of 1934, 15 U.S.C. § 78p(b)[1] to a conversion of preferred stock into common stock, which was then sold within six months of the conversion. Appellants, Petteys and Reavis, appeal from a judgment of the United States District Court for the District of Minnesota holding them liable for profits realized from the sale of Northwest Airlines, Inc. common stock in a transaction held to be a short-swing speculation proscribed by § 16(b). The cases were joined for trial and one opinion written by the District Court. Jurisdiction of the cases filed is founded upon § 27 of the Act, 15 U.S.C. § 78(aa), and upon 28 U.S.C. § 1331.

The facts of these cases are not in dispute. Petteys and Reavis are minority stockholders and were during the period in question, two of the thirteen directors of Northwest Airlines, Inc. (Company). On January 14, 1963, Petteys owned 5000 shares of the Company's 5¼% convertible cumulative preferred stock and 15,000 shares of common stock. Reavis owned 1167 shares of the preferred stock and 4000 shares of the common stock. Each had owned his stock for more than six months. On January

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[1] § 16(b) Securities Exchange Act of 1934, 15 U.S.C. § 78p(b):

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer * * *. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer * * *. This subsection shall not be construed to cover any transaction * * * which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

14, 1963, the Company had outstanding 449,615 shares of preferred stock and 1,388,459 shares of common stock. The common and preferred stock were listed and traded on the New York Stock Exchange; and the preferred stock was protected against dilution resulting from the issuance of additional common stock. The preferred and common stock each had one vote per share. Petteys had been a director since 1945 and Reavis since 1952. The preferred stock was convertible at any time on the basis of $25 for each preferred share into common stock at a conversion price of $26 for each common share plus accrued dividends prior to January 1, 1964.

At a meeting of the Company's board of directors on January 14, 1963, it was unanimously decided that the elimination of the preferred stock was desirable since this would place the Company in a more advantageous position to seek new capital. It was, therefore, unanimously decided to call for redemption of the preferred shares at $26.161815 per share on the entire outstanding issue ($26 redemption price plus accrued dividend). Both Petteys and Reavis were present at the directors' meeting. The market value of the preferred stock on this date was $34 per share, or about $8 more per share than the redemption price. The common stock of the Company at that time was selling for about $36 per share, which was approximately equal to the conversion rate of .9615 of common per share of preferred. Due to this wide difference between the market value of the stock and the redemption price, it was believed that the preferred shareholders would exercise their rights to convert their preferred shares into common prior to the redemption date of February 14, 1963. This judgment proved to be correct in that 99.98% of all the preferred shares were converted. Only 70 shares were not converted.

On January 17, 1963, when its market price was approximately $35 per share, Petteys converted his 5,000

shares of preferred stock for 4,808 shares of common stock. Less than six months after the conversion (between May 20 and June 18, 1963) Petteys sold 9,808 shares of common stock at prices ranging from 51 to 55½ per share.

Reavis converted his 1,167 shares of preferred stock on January 31, 1963, when the market value was approximately $38 per share and received therefor 1,123 shares of common stock. Less than six months later (June 5, 1963) Reavis sold 1,600 shares of common stock at prices ranging from 53¼ to 53⅝ per share.

On February 25, 1963, eleven days after the terminal date of the redemption call, the board of directors increased the quarterly dividend on its common stock from 20 cents to 25 cents per share. After the increased dividend, the market price of the common stock increased substantially.

The Minnesota suit, Number 18277, was filed July 2, 1964, in the District Court by Petteys and Reavis, seeking a judgment against the Company to the effect that these transactions were not proscribed short-term profits making them accountable therefor to the Company under § 16(a) and (b) of the Securities Exchange Act. On July 8, 1964, Eunice S. Butler, a stockholder, was granted leave to intervene to seek judgment on behalf of the Company. On July 14, 1964, the Company filed an answer, stating, "It is and has been unwilling to institute or prosecute an action against the plaintiffs." On July 17, 1964, Isadore Blau, another stockholder, instituted an action in the United States District Court for the Southern District of New York against Petteys, Reavis and the Company, alleging a § 16(b) liability of Petteys and Reavis to the Company. The New York case was then transferred to the District of Minnesota. Both cases were combined for a hearing on cross-motions for summary judgment. Sum-

mary judgment was appropriate as the facts were not in dispute.

The District Court denied Petteys' and Reavis' motions, granted the motions of intervener Butler and plaintiff Blau, and held, in an opinion reported at 246 F. Supp. 526 (D. Minn. 1965), that the conversion of the preferred stock into common stock constituted a "purchase" within the meaning of § 16(b), and therefore Petteys and Reavis were liable to the Company for profits derived from the sale of the common stock within six months after the date of "purchase" or conversion.

Petteys and Reavis contend that the conversion of preferred stock into common stock under the particular facts of this case was not a "purchase" within the meaning of § 16(b).

Petteys and Reavis, as directors, are "insiders"[2] under § 16(a) and subject to the requirements of § 16(a) and the civil liabilities of § 16(b). The only question remaining is whether their conversion of preferred stock into common stock constituted a purchase of the common so that the subsequent sale of common within six months thereafter would make them liable to the Company for any profit realized on the sale transactions. The fact that Petteys and Reavis had other common stock, purchased prior to the periods in question, from which their sales were, or could have been, made is immaterial.[3]

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[2] "Insiders" as denoted in cases and articles dealing with § 16(b) are those who are required to report under § 16(a) any sale or purchase of stock, and who are subject to the sanctions of § 16(b). They are: "16(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of equity security * * * or who is a director or officer of the issuer of such security, * * *."

[3] Although it is not clear whether the shares sold were the same certificates acquired in the conversion, this point is immaterial.

(Footnote continued on following page)

The reasons for the enactment of the Securities Exchange Act of 1934 and the specific purpose to be served by § 16(b) are fully documented and examined in prior § 16(b) cases discussed in this opinion, and will not be repeated in detail here. In summary, congressional investigations in the early 1930s disclosed a number of instances in which "insiders" of corporations had abused their fiduciary positions by using confidential corporate information to aid their personal market activities. Armed with information not available to ordinary stockholders, these "insiders" brought about artificial, but predictable, fluctuations in the market and, in so doing, were able to reap substantial profit with little or no investment risks to themselves—all at the expense of outside stockholders and the public. This manipulation and "sure thing" speculation discouraged valid investment and contributed to the cause and depth of the economic collapse of 1929. Congress, therefore, set out to remedy this particlar evil with § 16 of the Securities Exchange Act of 1934.[4]

Section 16(b) of the Act was enacted expressly "for the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer * * *." To implement this statement

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(Footnote continued from preceding page)

Equity securities are treated as fungible items. "(S)ince all shares of a corporation's stock are alike and interchangeable, it is of no consequence whether those bought and sold are represented by the same certificates." *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433, 434 (5 Cir. 1953), cert. denied 346 U. S. 820; *Smolowe* v. *Delendo Corporation*, 136 F. 2d 231 (2 Cir. 1943), cert. denied 320 U. S. 751; *Western Auto Supply Co.* v. *Gamble-Skogmo, Inc.*, 348 F. 2d 736 (8 Cir. 1965), cert. denied 382 U. S. 987.

[4] For a more complete discussion of the background and purposes of the Act, see *Smolowe* v. *Delendo Corporation*, 136 F. 2d 231 (2 Cir. 1943); *Blau* v. *Lamb*. . . . F. 2d . . . (2 Cir. June 27, 1966); Comment, 59 Yale L.J. 510 (1950); Comment, 45 Va. L.Rev. 949 (1959); Comment, 66 Harv. L.Rev. 385 (1953).

of purpose, the statute provides that profits realized by "insiders" from the purchase and sale, or sale and purchase, of equity securities of a company within a period of less than six months inure to the benefit of the company. This liability is enforceable by the company, or if the company fails to act, by a stockholder acting in a derivative capacity. The Act broadly defines "purchase" as "any contract to buy, purchase, or otherwise acquire," and "sale" as "any contract to sell or otherwise dispose of." 15 U.S.C. § 78(c)(13)(14).

The section establishes liability "irrespective of any intention on the part of (the insider)." Though perhaps reaching harsh results in individual cases, this arbitrary rule is thought necessary for the attainment of the goal set forth in the statute. If it were otherwise, "insiders" could continue all but the most blatant of practices and take refuge behind an artificial wall of good faith. Experience with the common law remedy had convinced Congress that actual proof of bad faith was a most difficult burden and thus discarded any subjective approach based on intent and established an objective sanction against so-called short-swing profits irrespective of intent. This sanction does not prohibit short-swing sales; it only takes away their profit from such transactions and places it in the corporation. Thus, the motivation for market manipulation is considerably depressed.

The courts have recognized the broad remedial purposes behind this section and when a transaction is capable of insider abuse they have liberally construed the rule and applied it without hesitation and without regard to good faith. See, *Smolowe* v. *Delendo Corporation*, 136 F. 2d 231 (2 Cir. 1943), cert. denied 320 U. S. 751; *Blau* v. *Lehman*, 286 F. 2d 786 (2 Cir. 1960), aff'd 368 U. S. 403; *Booth* v. *Carian Associates*, 334 F. 2d 1 (1 Cir. 1964), cert. denied 379 U. S. 961.

There is, however, a very different and difficult problem when a transaction falls within the literal boundaries of the Act, by giving a broad interpretation of the definitions of purchase as "any contract to buy, purchase or otherwise acquire," and sale as "any contract to sell or otherwise dispose of," yet due to the particular factual situation which makes unfair speculation impossible it is clearly beyond the Act's preventive purposes. In that situation the question arises, should the Act be literally applied without further inquiry and without regard to the purposes, or should the broad and arbitrary rules be applied only to situations which are capable of the abuse that the statute was designed to prevent? We believe that each case must be examined on its own facts and the Act only applied when these facts disclose the possibility of abuses that the Act were designed to prevent.

The first case dealing with the conversion of stock and the applicability of the "purchase" and "sale" provisions to a conversion, was *Park & Tilford, Inc.* v. *Schulte,* 160 F. 2d 984 (2 Cir. 1947), cert. denied 332 U. S. 761. In this case the "insiders" were in complete control of the corporation. At a time when the value of the corporation's preferred shares was above the call price, the "insiders" exercised their corporate control by having the corporation call the outstanding preferred on a given future date. They, of course, converted their preferred into common and within six months of the conversion sold the common at a substantial profit. The court held that the conversion was a "purchase" within the definition set out in the statute and a sale within six months made them liable to the corporation for the profit. On the facts of this case, the holding was undoubtedly correct. The preferred stock was not readily marketable and was not protected from dilution. Thus, it maintained a value independent of the common. As the "insiders" were able to set a call date at their will, they were in a position to use

inside information to determine this call date and to manipulate the independent values of the two securities to their profit. The court, however, in reaching its correct decision on the facts, used language unnecessarily broad. Loss, SECURITIES REGULATION, Vol. II, Ch. 6C(g), at page 1067 (2d ed. 1961). This language has since been interpreted as meaning that § 16(b) must be applied to all stock conversions and the strict terms of the statute are to be applied without regard to the purposes of the Act. See, *Heli-Coil Corp.* v. *Webster,* 352 F. 2d 156 (3 Cir. 1965).

Though understandable, this was probably an incorrect interpretation to place on *Park & Tilford,* in that the Second Circuit, which has more § 16(b) cases than any other circuit, has since refused to follow the broad implications of that case. Since *Park & Tilford,* the Second Circuit has examined each case on an *ad hoc* basis to determine whether the transaction came within the purpose of the Act. It specifically refused to be bound by a "black-letter rubric" or a "rule of thumb" as *Park & Tilford* supposedly demanded.

In *Shaw* v. *Dreyfus,* 172 F. 2d 140 (2 Cir. 1949), cert. denied 337 U. S. 907, the Court refused to hold that the receiving of a stock purchase warrant which was awarded equally to all shareholders was a "purchase" within the definition of the Act. The Court based its decision on the fact that, " 'inside' information which the directors may have, cannot possibly be used to the detriment of other stockholders * * *. Nor will the purposes of the statute be defeated * * *."

Roberts v. *Eaton,* 212 F. 2d 82 (2 Cir. 1954), cert. denied 348 U. S. 827, held that a reclassification of stock was not a "purchase" of the new stock. Judge Clark, the author of the *Park & Tilford* decision, stated at page 86, "The reclassification at bar could not possibly lend itself to the

speculation encompassed by § 16(b). This being so, it was not a 'purchase' * * *."

Even though the Court, in *Blau* v. *Lehman*, supra, held that a transfer came under the provisions of § 16(b), the Court stated at page 792 that a, "Transaction is a 'purchase' if in any way it lends itself to the accomplishment of what the statute was designed to prevent."

Though establishing a general approach contrary to the implications in *Park & Tilford*, these three cited cases did not involve the precise question of the treatment of conversions. *Park & Tilford* was still cited for the proposition that conversions must flatly be considered "purchases", without further inquiry. This was true, however, only until the recent Second Circuit case of *Blau* v. *Lamb*, . . . F. 2d . . . (2 Cir. 1966). The Court there was presented with a problem of whether the conversion of preferred stock into common stock constituted a "sale" of the preferred. In determining the correct approach for resolving this issue, Judge Waterman, for the Court, stated:

> "Aside from the intimations to the contrary in *Park & Tilford*, our court appears always to have recognized that in deciding whether a certain transaction is a Section 16 (b) 'purchase' or 'sale' it is relevant to first consider whether the transaction in any way makes possible the unfair insider trading that Section 16 (b) was designed to prevent. * * * The application of Section 16 (b) depends upon whether the transaction in question could tend to accomplish what the section was designed to prevent."

In looking at the particular circumstances of the conversion, the Court concluded:

> "(The) conversion afforded the insiders no opportunity to realize a gain by speculative trading in Air-

way Preferred. For this reason, we hold that the conversion was not a Section 16 (b) sale of the preferred."

With this case the Second Circuit limited *Park & Tilford* to its facts and completely destroyed any force found in the particular language of that decision intimating that a completely objective "rule of thumb" had to be applied in all conversion cases. The *Lamb* opinion relied heavily upon *Ferraiolo* v. *Newman,* 259 F. 2d 342 (6 Cir. 1958), cert. denied 359 U. S. 927, and *Blau* v. *Max Factor & Company,* 342 F. 2d 304 (9 Cir. 1965), cert. denied 382 U. S. 892. Judge Waterman, after reviewing the decisions, concluded that:

> "The decided cases in this and other circuits do not require us to hold that, without further analysis, the conversion * * * must be regarded as a Sec. 16 (b) 'sale'. * * * Instead, most of the appellate decisions, including the more recent decisions of our court, state that the application of Section 16(b) depends upon whether the transaction in question could tend to accomplish what the section was designed to prevent."

Also, see Judge Van Oosterhout's dissent in part in *Western Auto Supply Company* v. *Gamble-Skogmo, Inc.,* 348 F. 2d 736, at 745.

The facts in the *Ferrailo* case are almost exactly in point with the facts of the case at bar. A non-controlling director held convertible preferred stock. While the market was high the corporation called for a redemption at a price below the market. The director, of course, converted his preferred into common and, as here, sold the common within six months of the conversion. The Court stated, at page 345, "Every transaction which can reasonably be defined as a purchase will be so defined, if the transaction

is of a kind which can possibly lend itself to the speculation encompassed by Section 16 (b)." In examining the conversion on its particular facts, the Court concluded, at p. 346 of 259 F. 2d, that it was not a purchase because, "Newman's conversion of Ashland preferred to Ashland common had none of the economic indicia of a purchase; it created no opportunity for profit which had not existed since 1948. The transaction is not one that could have lent itself to the practices which Section 16 (b) was enacted to prevent."

Blau v. *Max Factor*, supra, concerned a situation where the insider held common stock which was in every way identical to Class A stock except the board of directors had the authority to declare less dividend on the common. Each had the same market value, same voting power and were fully convertible. The insider converted his common for Class A and sold the Class A within six months. The Court held, at pages 307-308 of 342 F. 2d:

> "(A) Transaction is held to be a 'purchase' within section 16(b) 'if in any way it lends itself to the accomplishment of what the statute is designed to prevent.' * * *
>
> "The exchange of Class A for Common did not interrupt the continuity of appellees' investment: it did not increase or decrease the amount invested, or alter in any way the risk assumed * * *. (T)he exchange conferred no opportunity for speculative profit which appellees did not already enjoy."

These two cases refused to apply a "rule of thumb," examined the facts of the case in the light of the purposes of the statute, and in each case concluded that the particular conversion did not constitute a "purchase" because there was no opportunity for speculative profit.

There is no doubt that the majority in *Heli-Coil Corp.* v. *Webster*, supra, takes an approach and reaches a result

inconsistent with the aforementioned cases. *Heli-Coil* expressly holds: "We conclude that Section 16(b) does set up a 'rule of thumb' and was intended by Congress to do precisely that." p. 166 of 352 F. 2d; but that is, however, at present a minority ruling and is founded almost solely upon the rationale of *Park & Tilford.* Since *Park & Tilford* has now been severely limited by the later Second Circuit decisions on this issue, we cannot refrain from the belief the *Heli-Coil* is likewise weakened.

Our decision in *Western Auto Supply Company* v. *Gamble-Skogmo, Inc.,* 348 F. 2d 736 (8 Cir. 1965), cert. denied 382 U. S. 987, was interpreted by the S.E.C. as indicating that we had adopted the so-called *Park & Tilford* objective approach to § 16(b) problems. Obviously, the facts of the two cases are not analogous. Even so, we find no dictum inconsistent with our holding herein. We held that the statute must be "liberally construed to carry out the express legislative policy" and that the good faith of the insider is no defense. This is a correct statement of the law that we will continue to follow. We certainly did not hold in *Gamble-Skogmo* that the statute must be literally applied even when the "express legislative policy" was not applicable to the factual situation under consideration.

Therefore, notwithstanding the broad language in the *Park & Tilford* case and the ruling in *Heli-Coil Corp.* v. *Webster,* we believe the rule has been clearly established by a majority of the circuits, that each case must be examined on its own particular facts. If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by § 16(b) and falls within the broad definitions of "purchase" and "sale", it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a § 16(b) label to the transaction. See, Comment, 59 Yale L. J. 510 (1950);

Loss, SECURITIES REGULATION, Vol. II, Ch. 6C(g), at pages 1069-1070 (2d ed. 1961); Comment, 45 Va. L. Rev. 124, 126 (1959).

A facet to consider as militating against painting every conceivable conversion with the same broad brush, regardless of the lack of opportunity for short-swing market manipulation, is the manifestly absurd and unfair result that can flow from such a *per se* black-letter rubric. As noted by Loss, supra, at 1068:

> "As a matter of fact, if every conversion involved both a 'purchase' of common and a 'sale' of preferred, no director or officer or 10 per cent beneficial owner could ever buy preferred or sell common in the market without the risk that a forced conversion within the next six months would subject him to liability."

The conversion transactions have been variously referred to as "statutory purchases," *Blau* v. *Max Factor*, supra, and "unorthodox 'purchase and sale' cases." See Loss, supra. They are not true sales but represent a type of exchange of equivalents that can be read into a literal interpretation of the § 16(b) language of "otherwise acquire" and "otherwise dispose of".

Undoubtedly, Congress realized that with such all-inclusive definitions there would be situations in which the definitions would be applicable yet the transactions would be of a nature that was not comprehended as being within the purposes of the Act. Congress specifically gave authority to make this determination to the Securities and Exchange Commission so that an administrative interpretation could facilitate enforcement of the Act and yet prevent undue hardship on those caught in the web of a categorically broad proscription. We have not been convinced that this authority is the exclusive prerogative of the S.E.C. and is not also subject to adjudication by the courts. Courts have always been, and should be, reluctant

to impose broad stautory rules that result in purposeless and unnecessary harshness. When the reason of the law ceases, the law itself ceases (to operate), is a well-known and time-proved rule of construction that is appropriate in this case. *Cessante ratione legis, cessat et ipsa lex.* See *Blau* v. *Lamb*, supra. Since the purposes of the Act are stated clearly and appear side-by-side with the literal demands, we do not believe we have been precluded by Congress from pursuing an equitable and historic role by examining the facts of each case in the light of the stated goals to determine on an *ad hoc* basis whether the purposes of the Act are in any way being served by an application of the literal provisions. If no purpose is served by attaching the artificial label of "purchase" to a transaction when it has none of the common indicia of a purchase, no such label is demanded, nor will one be attached. This, we believe to be the correct law and it is the law to be applied by us to the facts of this case.

As a general proposition, conversions of equity securities are not transactions which normally lend themselves to short-swing speculation. 59 Yale L.J. 510 (1950). This is not to say that the vehicle of conversion may not, under any circumstances, be used for the purposes of unfair speculation. We can envision in the abstract a combination of facts and events in which insiders might gain an unfair advantage by the exercise of their conversion rights, and no doubt clever individuals conversant with the subject can envision many. However, so unlikely is abuse of the contractual conversion privilege that the S.E.C. with its considerable expertise and years of experience in dealing with these matters, has concluded that the conversion of equity securities is not even comprehended within the purposes of § 16(b) of the Act. Pursuant to its statutory authority, on February 17, 1966 the S.E.C. amended Rule 16b-9, 17 C.F.R. § 240.16b-9 to read, in its pertinent part, as follows:

> "Exemption from Section 16(b) of Transactions involving the Conversion of Equity Securities.

> (a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of Section 16(b) of the Act;"

In its *amicus* brief to this Court, the S.E.C. has argued that this rule must be applied prospectively only and that since the conversion, as well as the trial, preceded the enactment of the rule it should not be applied as a matter of law to the case now before us. Given the law set forth herein, whether this exemption should be applied retroactively to conversions capable of abuse, we need not decide. From an examination of the facts before us, the unique facts of this particular case, we are convinced that no unfair speculation was possible. The necessarily rare combination of many factual elements which would make short-swing speculation possible are not present herein. The conversion of the securities thus did not constitute a "purchase" within the meaning of the statute, and appellants, Petteys and Reavis, consequently are not liable for any profit received by a subsequent sale. The retroactivity of this new rule is thereby rendered a moot question.

The preferred stock held by the two directors was fully marketable and listed on the New York Exchange. It was protected against dilution, had equal voting power, was fully convertible and at all times maintained a market value equivalent to the common. The conversion did not increase or decrease the amount invested, change the proportion of ownership, affect voting rights, or substantially alter the risk assumed. *Blau* v. *Max Factor*, supra. Thus, it appears to us that the common and preferred are truly "economic equivalents" in which speculation from their

conversion would be virtually impossible. *Ferraiolo* v. *Newman,* supra; *Roberts* v. *Eaton,* supra.

In facing a call of the preferred, if the directors wanted to maintain their investment, which they had every right to do, the only course open to them was a conversion. Unlike *Park & Tilford,* where the controlling directors unilaterally decided to call the preferred and themselves established the call date, the directors herein were not in control of the corporation. The call date was set and, to maintain their long-term investment in the corporation, they had no choice but to convert. This conversion being "forced" upon them, it is not a type of situation that one can normally expect to use for a profitable speculation. *Ferraiolo* v. *Newman,* supra.

In the case before us, the stockholders were adequately informed of the proposed call. Substantially all of the shareholders responded to the economic demands of the call, and, like Petteys and Reavis, converted their preferred for common rather than suffer a needness and substantial economic loss. With nearly all of the outstanding preferred shares being converted (99.98%), we cannot envision how directors Petteys and Reavis, by their conversion, could gain an unfair advantage over the other shareholders. In reality, all were treated alike and thus none was vulnerable to unfair advantage due to access to inside information. Even the assumed inside knowledge of the future dividend increase, in this case, did not open up possibilities of abuse, as all preferred shareholders converted for common and thus received the increased dividends and the benefit of consequent market rise (the 70 shares not converted are treated as *de minimis*). Since all shareholders remained in an equal position, none was, or could have been, taken advantage of by the conversion of an insider. *Shaw* v. *Dreyfus,* supra.

It is, therefore, our conclusion that this particular transaction under the facts and circumstances of this case could not possibly have lent itself to the speculation encompassed within the purposes of § 16(b) of the Act. This being so, the conversion should not be considered as a "purchase" within the purview of the Act's provisions. Our position on this conclusion is supported, we believe, by the like conclusion in *Ferraiolo* v. *Newman*, the analogous cases of *Blau* v. *Lamb*, and *Blau* v. *Max Factor*, and by the rationale of the recent ruling of the S.E.C. amended Rule 16b-9, acknowledging that conversions are not the type of "transactions" that are "comprehended within the purposes of Section 16(b)."

While our decision is not based on the S.E.C. amended Rule 16b-9 dealing with conversions, the rule is noted as a recognition of the rationale that ordinarily conversions are not purchases or sales. The contract rights of conversions are secured at time of purchase of the convertible security. And, as aptly reasoned in *Blau* v. *Lamb*, at . . . of . . . F.2d . . . :

> "We think that in cases like the present involving the purchase of a convertible security and its subsequent conversion, the issue should be whether the underlying security has been sold within six months from the acquisition of the convertible security." (Noting the dissent in part of Judges Hastie and Kalodner in *Heli-Coil*).

A like application would place the transactions at bar beyond not only the purposes of the Act but also the broad terms thereof.

Accordingly, judgment is reversed with instructions to grant judgment in favor of appellants.

Dissenting Opinion

BLACKMUN, Circuit Judge, dissenting:

Having been a member of the majority in *Western Auto Supply Co.* v. *Gamble-Skogmo, Inc.*, 348 F.2d 736 (8 Cir. 1965), cert. denied 382 U. S. 987, I feel obliged respectfully to dissent. While that case and this one are factually different, I suspect that the results are philosophically inconsistent. I also wonder whether our decision in *Gamble-Skogmo* might not, in part at least, have prompted Judge Nordbye to decide oppositely in the two cases at the trial level.

The majority seem to concede that the conversion here "falls within the literal boundaries of the Act" and "can be read into a literal interpretation of the § 16(b) [§ 3 (a)(13) and (14)] language of 'otherwise acquire' and 'otherwise dispose of' ". Further, I bear in mind the inescapable facts here (a) that these plaintiff-directors voted for the call of the preferred; (b) that they voted for the increase in common dividend effective shortly thereafter; (c) that their increments of ownership in the corporation after the conversion were exactly the same as they would have been had they sold their preferred on the open market and forthwith used the proceeds of that sale to purchase common on the market; and (d) that in the latter situation, with the ensuing sale of common, no one would or could dispute the applicability of § 16(b) and the consequent liability of the plaintiffs. These facts, it seems to me, add up to the possibility of misuse of inside information. And this mere possibility suffices.

My own reaction is that either the statute means what it literally says or that it does not; that if the Congress intended to provide additional exceptions, it would have done so in clear language; and that the recognized purpose and aim of the statute are more consistently and protec-

tively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case application. The latter inevitably is a weakening process.

However, with the Second Circuit now clearly withdrawing from Judge Clark's broad measure of § 16(b) as expressed in *Park & Tilford, Inc.* v. *Schulte,* 160 F.2d 984 (2 Cir. 1947), cert. denied 332 U.S. 761, the Courts of Appeals, other than the Third Circuit's 6-2 en banc majority in *Heli-Coil Corp.* v. *Webster,* 352 F.2d 156 (3 Cir. 1965), appear now to prefer to follow the *ad hoc* path. The Supreme Court ultimately may say that that view is to be preferred. At least, Mr. Justice Stewart's attitude is apparent from his authorship of the opinion in *Ferraiolo* v. *Newman,* 259 F.2d 342 (6 Cir. 1958), cert. denied 359 U.S. 927. Until the Supreme Court does so state, however, I must, in good conscience, adhere to my literal and objective construction preference.

I confess that my persuasion has been deeply shaken by the Security and Exchange Commission's recent about-face with its amendment of its Rule 16b-9, 17 C.F.R. 240.166-9, and its announced position that from and after February 17, 1966, a conversion of this kind is outside the statute and not touched by it, but that these plaintiffs' particular conversions, effected prior to that date, are within the statute and subject to its consequences. I am not entirely sure that Congress, by the subsection's final sentence, meant to give the Commission the power so to legislate at will by abruptly changing the reach of the statute which it had regarded otherwise for over a generation, or that, if it did, such delegated authority is not vulnerable to attack, or that the announced new rule is consistent with the statute anyway. But these are issues which we need not now decide.

Perhaps the Supreme Court one day soon will tell us how these somewhat conflicting approaches to § 16(b) by the Courts of Appeals are to be resolved. In the meantime, I would affirm.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

Judgment of Reversal.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

September Term, 1966

Alonzo Petteys and C. Frank Reavis, No. 18277. Appellants, vs. Eunice S. Butler and Northwest Airlines, Inc.	Appeal from the United States District Court for the District of Minnesota.
and	
Alonzo Petteys and C. Frank Reavis, No. 18278, Appellants, vs. Isadore Blau and Northwest Airlines, Inc.	Appeal from the United States District Court for the District of Minnesota.

These causes came on to be heard on the record from the United States District Court for the District of Minnesota, and were argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the judgment of the said District Court in these causes be, and the same is hereby, reversed with costs, and that Alonzo Petteys and C. Frank Reavis have and recover against Eunice S. Butler; Northwest Airlines Inc., and Isadore Blau the sum of Dollars for their costs in this behalf expended, and have execution therefor.

And it is further Ordered by this Court that these causes be, and they are hereby, remanded to the said District Court with instructions to grant judgment in favor of appellants, Alonzo Petteys and C. Frank Reavis, in accordance with the majority opinion of this Court this day filed herein.

October 19th, 1966.

Statutes.

Sections 16(a) and Section (b) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sects. 78p(a) and 78p(b), provide as follows:

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78 (g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such months shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good

faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78c(a)(13), provides as follows:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

Section 3(a)(14) of the Securities Exchange Act of 1934, 15 U.S.C.A., Sect. 78c(a)(14), provides as follows:

"The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 755

ISADORE BLAU, a stockholder of Northwest Airlines, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Northwest Airlines, Inc.,

Petitioner,

—v.—

ALONZO PETTEYS and C. FRANK REAVIS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

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IN THE

Supreme Court of the United States

October Term, 1966

ISADORE BLAU, a stockholder of Northwest Airlines, Inc., suing on behalf of himself and all other stockholders similarly situated and on behalf and in the right of Northwest Airlines, Inc.,

Petitioner,

—v.—

ALONZO PETTEYS and C. FRANK REAVIS,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR RESPONDENTS IN OPPOSITION

Question Presented

Is the conversion, by a non-controlling director, of listed convertible preferred stock into listed common stock of the same issuer a "purchase" of the common stock within the meaning of Section 16(b) of the Securities Exchange Act of 1934 in a case in which all convertible preferred stock outstanding had been called for redemption at a redemption price substantially below the market price of the convertible preferred stock, and the convertible preferred stock and the common stock into which it was convertible were economic equivalents in the market place?

Summary of Bases for Denial of Petition

1. The question presented by the decision below is no longer important since the Securities and Exchange Commission on February 17, 1966 adopted Rule 16b-9, which by its terms exempts from the operation of Section 16(b) of the Securities Exchange Act of 1934 (the "Act") all conversions of an equity security into another equity security of the same issuer. That rule governs all transactions after its date. No similar case can therefore arise in the future. Accordingly, no "special and important reasons" exist for granting the writ.

2. There is no decision of any Court of Appeals in conflict with the decision of the Court of Appeals for the Eighth Circuit in this case. In the one other case presenting the same set of facts, *Ferraiolo* v. *Newman,* 259 F. 2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959), the Court reached an identical result.

3. The decision below is correct.

Statement of Facts

Petitioner seeks review of the decision of the Court of Appeals for the Eighth Circuit denying recovery under the short swing profit recovery provisions of Section 16(b) of the Securities Exchange Act of 1934. The basis of the decision was that conversion of convertible preferred stock into common stock under the circumstances of the case was not a "purchase" within the meaning of that section.

The facts are not in dispute. They were stipulated, and all parties except Northwest Airlines, Inc. ("Northwest") moved for summary judgment.

This case is one of conversion of convertible equity securities (convertible preferred stock) into common stock

of the same issuer after the preferred stock had been called for redemption. The respondents, both directors of Northwest were two of the fourteen directors of that corporation (R. 24a, 25a).[1] They were not in control, either by reason of ownership of stock or otherwise, and held relatively minor percentages of its stock, that of Mr. Petteys amounting to 5,000 shares of the 449,615 shares of the convertible preferred stock outstanding and that of Mr. Reavis amounting to only 1,167 shares of such stock (R. 23a-25a, 27a, 67a). Their holdings of common stock prior to the conversion amounted to 15,000 shares and 4,000 shares, respectively, out of a total of 1,388,459 shares outstanding (R. 22a-24a). All the common and preferred stock in question had been held by them for more than six months prior to the call for redemption (R. 23a, 24a).

The redemption price was only approximately 75% of the market price at the time of the call (R. 26a). The convertible preferred was fully protected against dilution and both the preferred and the common were listed on the same exchange (The New York Stock Exchange) (R. 22a). The result was that the market price of the preferred and the common were at all times in fixed relation to each other in a proportion corresponding with the conversion rate, that is, .9615 of a share of common stock for each share of preferred (R. 28a).

Virtually all the preferred stock was converted prior to the redemption date, the holders of only 70 of the 449,615 shares outstanding at the time of the call failing to convert (R. 27a).

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[1] References are to pages of the record certified to this Court by the Clerk of the United States Court of Appeals for the Eighth Circuit.

The preferred stock was convertible at any time prior to January 1, 1964 (R. 22a). On January 14, 1963 the directors called the preferred for redemption on February 14, 1963. This action was taken by resolution adopted unanimously by the Board of Directors (R. 25a). The two Respondents voted for the resolution. The market price of the common stock was then $36 and that of the preferred stock was about $34 per share (R. 28a). Compared with this market price, the redemption price of the preferred was only $26.18 per share, that is, $26 plus 16.1815 cents for dividends accrued through February 14, 1963 (R. 25a).

All stockholders were immediately notified of the action and, as noted, except for 70 shares, all shares, including those of the Respondents, were converted prior to the redemption date (R. 25a, 26a, 67a). On February 25, 1963, the Board of Directors declared a quarterly dividend on the common stock of 25 cents per share, an increase of 5 cents per share.

Within six months after conversion each Respondent sold common shares in excess of the number of shares he had received upon redemption at prices exceeding the market price at the time of conversion (R. 26a, 27a).

On February 17, 1966, the Securities and Exchange Commission adopted an amendment to Rule 16b-9, 31 Fed. Reg. 3391 (1966), amending 17 C.F.R. 240.16b-9 (1964), exempting from Section 16(b) transactions involving the conversion of a convertible equity security into another equity security of the same issuer. The rule is set forth in the Appendix. It was prospective in application.

The decision in the District Court in the instant case was handed down before the adoption by the SEC of its rule

that no conversion of equity securities is a purchase. In its decision the District Court decided for the Petitioners, holding that all conversions of one stock into another are purchases within the broad language of Section 3(a) (13) of the Act and hence that the facts in the instant case were immaterial.

The Court of Appeals, following *Ferraiolo* v. *Newman, supra,* held that Section 16(b) did not apply to an involuntary conversion involving economically equivalent equity securities, and reversed the decision of the District Court. The Court also made reference to the fact that the SEC has now ruled that no conversion is a purchase, although the Court found it unnecessary to rely on this.

ARGUMENT

1. No Special and Important Reasons Exist for Granting the Writ Since the Question Can No Longer Arise by Reason of Newly Adopted Rule 16b-9.

The Supreme Court denied certiorari in 1959 of a case presenting the identical question presented in this case, *Ferraiolo* v. *Newman, supra, cert. denied,* 359 U.S. 927 (1959). There is even less reason today for consideration of the issue, since the SEC has promulgated a new rule exempting transactions of this nature from the application of Section 16(b) of the Act. The Securities and Exchange Commission on February 17, 1966 adopted an amendment to Rule 16b-9. That rule, with certain exceptions not here pertinent, exempts from Section 16(b) any acquisition or disposition of an equity security upon the conversion of an equity security into another equity security of the same issuer. Thus, any conversion of the type here present which

occurs after February 17, 1966 is, under the terms of the rule, exempt from the operation of Section 16(b).

No special or important reasons exist for consideration by this Court of a question which has been removed from controversy by rule of the Commission. In the circumstances the writ should be denied. *Rice* v. *Sioux City Cemetery*, 349 U.S. 70 (1954); *United States* v. *Abrams*, 197 F. 2d 803 (6th Cir. 1952), *cert. denied*, 344 U.S. 855; *District of Columbia* v. *Sweeney*, 310 U.S. 631 (1939); see Stern, *Denial of Certiorari Despite a Conflict*, 66 Harv. L. Rev. 465 (1953).

2. No Conflict of Decisions Exists.

There is no decision of any United States Court of Appeals in conflict with the decision of this case. No United States Court of Appeals has held a non-controlling insider liable under Section 16(b) of the Securities Exchange Act of 1934 where the convertible security was converted into another, economically equivalent, equity security of the same corporation after all the convertible issue had been called for redemption and the redemption price was below the market price of the convertible security and the corresponding price of the security into which it was convertible. In the only other Court of Appeals case dealing with this fact situation, *Ferraiolo* v. *Newman*, *supra*, the Court reached a result identical with the present case.

The case of *Heli-Coil Corporation* v. *Webster*, 352 F. 2d 156 (3d Cir. 1965), is not a conflicting decision. It did not present the same question. Among the significant differences were these:

1. The convertible securities in that case had not been called for redemption. There was, therefore, no

question of necessity to convert to avoid redemption at a price lower than the market. Thus, the conversion was in effect voluntary. Indeed, only 22% of the outstanding debentures were converted. The conversion did not result from a call affecting all debentureholders but instead was made upon the recommendation of an investment banker to a few holders of the debentures, including the defendant director who had been recommended for election to the Board of Directors by the banker.

2. The convertible securities in that case were debt securities, that is, convertible debentures not convertible preferred stock. Their conversion involved a change from debt status to equity status, with a consequent effect upon the company's balance sheet, borrowing power and equity values.

3. The debentures were not listed, while the stock was. The result was a possible lag in price adjustment, so that the exact economic equivalent which existed in this case and the *Ferraiolo* case, *supra*, was not present in *Heli-Coil*.

These differences were critical, since they presented the Court with the possibility of violation of the purposes of Section 16(b). Indeed, one of the reasons for the conversion in the *Heli-Coil* case was the belief that the elimination from the balance sheet of the debt represented by the converted debentures would increase the value of the common stock into which the debentures were converted. The Court there stated: "This seems to be an instance when a decision to convert could involve speculative or subjective judgment as to trading advantages to be anticipated in holding stock rather than convertible debentures." (352 F. 2d 156, 165 (3rd Cir. 1965).)

In the instant case the Court of Appeals for the Eighth Circuit said in its opinion:

> "If, from an examination of the particular facts, a transaction is of a kind that can possibly lend itself to the speculation encompassed by § 16(b) and falls within the broad definition of 'purchase' and 'sale', it will be so defined. However, if an examination of the facts indicates that there is no possibility of abuse, there is no need to apply a § 16(b) label to the transaction."

It thus is apparent not only that there is no conflict in the decision, but that the Court of Appeals for the Eighth Circuit might, in the *Heli-Coil* case, have reached the same result as that reached in it by the Court of Appeals for the Third Circuit.

3. The Decision Below Is Correct.

The Court of Appeals examined the facts in their relation to the purposes of the statute. In this it was applying the time-honored function of the Courts to interpret the Act in a manner to effectuate its purpose. There is nothing in the legislative history of the Act or in the Act itself to suggest that Congress intended to exclude the Courts from their proper function.

The Court did not attempt to determine the subjective intention of the respondents. What it did was to determine, viewing the facts objectively, that there was no possibility of the abuse sought to be reached by the Act. Accordingly, the Court said that "there is no need to apply a § 16(b) label to the transaction". The holding is manifestly cor-

rect. It involves a set of facts identical with that in *Ferraiolo* v. *Newman, supra*, and follows that authority.

Both the rationale of the decision of the Circuit Court and the result are confirmed by the SEC's newly promulgated Rule 16b-9 which has as its premise the finding by the SEC that conversion transactions of the type here present are not comprehended within the purposes of Section 16(b). This is objective confirmation based upon the Commission's experience that this type of transaction does not have within it the seeds of abuse. The decision was clearly correct.

CONCLUSION

The petition seeks review of a decision that (i) presents no special or important reasons for review by this Court, (ii) is not in conflict with a decision of the Court of Appeals of any other circuit, and (iii) is clearly correct. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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December 7, 1966

APPENDIX

Rule 16b-9 Under the Securities Exchange Act of 1934
(Effective February 17, 1966)

Exemption from section 16(b) of transactions involving the conversion of equity securities.

(a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer, shall be exempt from the operation of section 16(b) of the Act: *Provided, however,* That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under section 16(b)) within a period of less than 6 months which includes the date of conversion.

(b) For the purpose of this section, an equity security shall not be deemed to be acquired or disposed of upon conversion of an equity security if the terms of the equity security converted require the payment or entail the receipt, in connection with such conversion, of cash or other property (other than equity securities involved in the conversion) equal in value at the time of conversion to more than

15 percent of the value of the equity security issued upon conversion.

(c) For the purpose of this section, an equity security shall be deemed convertible if it is convertible at the option of the holder or of some other person or by operation of the terms of the security or the governing instruments.